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COMPETITION IN THE RAILROAD INDUSTRY

OPENING COMMENTS OF
ALLIANCE FOR RAIL COMPETITION
MONTANA WHEAT & BARLEY COMMITTEE
COLORADO WHEAT ADMINISTRATIVE COMMITTEE
IDAHO BARLEY COMMISSION
IDAHO WHEAT COMMISSION
KANSAS WHEAT COMMISSION
NEBRASKA WHEAT BOARD
OKLAHOMA WHEAT COMMISSION
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The Alliance for Rail Competition (ARC), its members, including PPL Energy-Plus LLC, specified agricultural Commissions, and the National Association of Wheat Growers hereby provide their comments in this proceeding. Collectively, these commenting parties will be referred to hereafter as ARC, et al. In addition to supporting these comments, ARC, et al. support joint comments being filed by American Chemistry Council, et al. Many of the interests supporting these comments are also parties to the ACC joint comments.

The main purpose of these comments is to urge the Board not to lose sight of shippers' need for protection against unreasonable rail rates and unreasonable railroad practices as it directs its attention to competition issues. In many regions of the country, and particularly for shippers of agricultural commodities in large Western states that are predominantly rural, rail-to-rail competition is non-existent for most shippers, and is likely to remain non-existent, no matter how much effort the Board puts into eliminating or reducing anticompetitive policies and precedents. Distances are simply so great, and individual origin volumes so small, that attracting effective competitors for monopoly incumbent railroads is unlikely under any circumstances.

The USDA/DOT Study of Rural Transportation Issues issued in April 2010 helps illustrate the problem. In Chapter 6, at pp. 214-224, maps indicate that crop reporting districts in many Western states have lost the equivalent of 4.25 to 2.58 competing railroads serving grain and oilseed markets. Crop reporting districts with R/VCs from 180-240 increased from 10 in the period 1985-92 to 24 in the period 2003-2007, and significantly higher R/VCs have been calculated on grain rates in areas of the West, including Montana and North Dakota.

The Report also provides inverse Herfindahl-Hirshman Index (HHI) values for crop reporting districts, explaining (p. 217) that an inverse HHI below 1.25 indicates weak rail-to-rail competition with one of two railroads dominant, and a figure of 1.00 "indicates a rail monopoly." In the map on page 221, large swaths of Montana, the Dakotas, Idaho, Washington, Utah, Colorado and Nebraska are depicted as having inverse HHIs of 1.00, and much of the West shows values of 1.00-2.00.

The central premise of the Staggers Rail Act of 1980, which ARC, et al. support, is that where competition is present and effective, much economic regulation may be unnecessary.[1] These principles underlie not just rail deregulation but also deregulation of other industries, and much of American economic policy. Equally important, moreover, is the proposition that where competition is absent or ineffective, regulatory remedies against abuses of market power must be preserved.

In past years, the ICC and STB have too often denied relief to captive shippers based on the appearance rather than the reality of competition. See, e.g., Arizona Public Service Co. v. United States, 742 F. 2d 644 (D.C. Cir. 1984), in which the D.C. Circuit recited numerous forms of alleged competition cited in support of declining to find market dominance, most of which were non-existent, and all of which were ineffective. As the court pointed out:

> At the core of the "effective competition" standard is the idea that there are competitive, market pressures on the railroads deterring them from charging monopoly prices for transporting goods. Of course, any such effective competition will always be relative to a particular price that the railroads charge. At some point the availability of an alternative such as the horse and buggy or even people carrying oil in buckets theoretically prevents railroads from raising

[1] Even in competitive markets such as trucking, safety regulation and general commercial regulation of financial and business practices, equipment, labor practices, etc. are recognized as necessary.

> their rates beyond an outer bound. But the mere existence of some alternative does not in itself constrain the railroads from charging rates far in excess of the just and reasonable rates that Congress thought the existence of competitive pressures would ensure.

At the same time, Professors Baumol and Willig, who became frequent witnesses for the railroads in ICC rulemaking proceedings, were developing their theory of contestable markets, under which it is posited that a firm with apparent monopoly power may act like a firm facing competition due to the possibility that, absent barriers to entry, other firms could enter the market and charge less or provide better service than the incumbent.

Of course, here again, apparent competition must not be confused with real or effective competition. Even if second railroad actually can and does serve an origin or destination, effective competition may be missing. The shipper may simply have the choice of two railroads, both of which charge excessive rates, impose new charges, provide poor service, force the shipper to absorb costs and burdens formerly borne by railroads, or all of these. The assumption that actual "competitors" always or even usually compete vigorously or at all is a dangerous fallacy.

It is even more dangerous to assume that the possibility of competition in a market served by a single railroad, e.g., a contestable market, can be considered subject to effective competition, absent evidence of reasonable rates, service quality, etc. For these reasons, Congress was wise to define market dominance not as the absence of competition, but rather as the absence of <u>effective</u> competition. 49 U.S.C. § 10707(a).

For decades, the ICC and STB have underemphasized the need to provide effective regulation whenever effective competition is absent. The current proceeding suggests a welcome, if belated, consideration of revisiting several past decisions which have served to increase railroad market power by decreasing competition.

Prior agency decisions on the Bottleneck issue, competitive access remedies under 49 U.S.C. § 11102, and the paper barriers that have limited even the possibility of short line competition for Class I railroads, can and should be revisited. ARC, et al. urge the Board, in the wake of this proceeding, to initiate further proceedings to reconsider its anticompetitive precedents in all of these areas, and others mentioned in the Board's Notice.

At the same time, the Board must recognize that completely reversing its policies and making Bottleneck rates, competitive access, and relief from paper barriers readily available, however desirable, will not ensure that railroad monopoly power is replaced with effective competition.

Reversing the Bottleneck Decisions is unlikely, by itself, to lead to rate reductions. Rather, it will require incumbent monopoly railroads to publish rates to interchanges with potential competing railroads. These bottleneck rates may then be subject to challenge in rate cases that may be simpler and less expensive than proceedings that must show the unreasonableness of rates covering entire movements from origins to destinations, as is the rule today. This change is desirable, particularly because it reduces the danger that the incumbent monopoly railroad will leverage its monopoly over the bottleneck segment in such a way as to defeat rate relief under current rate reasonableness methodologies.[2]

[2] Assume a bottleneck rate is charged by railroad A over a short stretch to an interchange with railroads B and C, which compete with each other for long hauls that make up the non-bottleneck segments. Competition between railroads B and C might keep total rates low enough to shield even an exorbitant bottleneck rate by railroad A from successful challenge.

However, filing a rate case at the STB is still prohibitively expensive for many captive shippers, and relief is capped at unreasonably low levels under the Board's SSAC and Three Benchmark approaches. Since railroads are subject to no penalty for abusing their market dominance – at worst, they must return amounts they should not have collected in the first place – there is little reason to expect that railroads required to publish Bottleneck rates will publish rates that do not extract monopoly rents.

Indeed, discussions on Capitol Hill concerning S. 2889, the Surface Transportation Board Reauthorization Act of 2009, a bill which died in the last session of Congress after being approved unanimously by the Senate Commerce Committee, are instructive in this regard. Major railroads reportedly argued that they should be required to publish bottleneck rates only if they were allowed to charge rates for the bottleneck segment that would allow them to retain profit margins they enjoyed from rates applicable to the entire movement. Absent penalties for such conduct, reversal of the Bottleneck Decisions may simply lead to astronomical bottleneck rates, which could help shippers with pockets deep enough to bring SAC cases, but provide little or no help for smaller captive shippers.

Reversing the Bottleneck Decisions can be considered pro-competitive to the extent that it recognizes the importance of deregulating rail service where effective competition exists, even if real relief will be unlikely without prescribed rate reductions. However, properly understood, Bottleneck relief can be more accurately described as facilitating and simplifying litigation than as promoting competition.

In contrast, reversing the ICC's Midtec decision[3] and giving effect to the intent of Congress in providing for access remedies, including reciprocal switching and terminal trackage rights, in 49 U.S.C. § 11102, would be pro-competitive. The same is true of granting relief from paper barriers. In both cases, shippers formerly captive to a single railroad might have access to two.

Reversing ICC and Board policies on competitive access and paper barriers, though necessary, is unlikely in itself to be sufficient. As with Bottleneck relief, major railroads are likely to argue that the price of access remedies and relief from paper barriers should be set so high as to neutralize the effectiveness of the relief. Absent barriers to excessive access charges and paper barrier buyout compensation, these competitive remedies may also necessitate invocation of STB regulatory remedies.

In the unlikely event that major railroads do not demand exorbitant access fees and buyout prices, these competitive remedies will, at best, lead only to the possibility of competition by a second railroad, and will not necessarily lead to the effective competition that may render regulatory remedies unnecessary. Railroads that become able to compete as the result of reform of the Board's competitive access and paper barrier policies may prove no more ready to provide effective competition than those railroads that today are able to compete but choose not to.

There is a third obstacle to the effectiveness of reform in all three areas of inquiry in this proceeding – Bottlenecks, access remedies, and paper barriers, etc. – that is of

[3] Midtec Paper Corp. v. Chicago and North Western Transportation Co., 3 I.C.C. 2d 171 (1986), aff'd. Midtec Paper Corp. v. United States, 857 F. 2d 1487 D.C. Cir. 1986).

immediate concern to ARC. There are many shippers, particularly in the Western U.S., for whom competitive remedies are not likely to be helpful.[4]

Many such shippers are hundreds of miles from even a potential competitor, and do not offer freight in sufficient volumes to attract the interest of a second railroad, even if a second railroad were allowed to provide service, and were inclined to provide effective competition, e.g., by charging rates at 210% of variable cost where the incumbent charges 250% of variable cost, or supplying cars at reasonable cost where the incumbent requires shipper-provided cars or imposes unreasonable car supply charges

For such shippers, and others, it is imperative that the Board continue to enforce the Act's prohibitions against unreasonable rates and unreasonable practices, at the same time that it is considering ways to make its competitive remedies more effective. In fact, given the difficulty of achieving lower rates and/or improved service through competitive remedies alone, the Board should consider ways to improve the effectiveness of regulatory as well as competitive remedies.

Railroad consolidations may have produced some efficiencies, such as labor force reductions and less circuitous routings, though the benefits of any such gains for shippers have been overstated. However, the fact that we now have, in essence, duopolies in the East and West, and that the four largest Class I railroads control more than 90% of rail freight, with too little competition from short lines and too little competition among the

[4] Notably, in its Final Report issued in January 2011 in its Rail Freight Service Review, Transport Canada concluded that rail service for Canadian shippers (many of which are comparable to Western agricultural shippers in the U.S.) had been less than adequate. However, the Report also found that "there are no practical ways to directly increase rail competition." Report at page 47. It should be remembered that Canada already has more competitive remedies than are available in this country, so the possibility of increased competition is greater in at least some parts of the U.S.

Class Is themselves, also has adverse impacts on shippers, the economy and the public interest.

Railroads with no competition can and generally do charge higher rates. Higher rates, on average, for captive shippers have been the rule for many years, even if conscious parallelism and reduced capacity have enabled railroads to avoid or limit price competition. Of course, to the extent that railroads are able, for whatever reason, to charge higher rates across the board and achieve or exceed revenue adequacy, there is all the more reason for the STB to protect captive shippers, as well as smaller and more isolated shippers. Such shippers have contributed more than their share to the railroad industry's financial strength.[5]

In addition, railroads without effective competition can and do impose excessive ancillary charges. These charges are an increasing problem for shippers, both because they are growing in number and size, and because there is no clear way to challenge their reasonableness. The Board has standards for the reasonableness of rates, some guidelines for fuel surcharges and some precedents on demurrage charges, but standards for testing when other charges are unlawfully high are vague or nonexistent.

Challenging the level of a charge using SAC, SSAC or Three Benchmark is infeasible, and railroads frequently argue that the levels of charges can only be challenged after a finding of market dominance. Accordingly, many challenges have invoked STB unreasonable practice jurisdiction rather than unreasonable rate jurisdiction.

Railroads with no effective competition are also more likely to engage in arguably unreasonable practices, such as failing to provide service, or providing service only on

[5] Between 1980 and 1996, the only way shippers to challenge rail rates as unreasonably high was under the Full-SAC method adopted in Coal Rate Guidelines for utility coal shippers. Shippers for whom full-SAC did not work, which is to say virtually all non-utility captive shippers in the U.S., were remediless.

terms that adversely affect shipper operations, or imposing new costs or burdens on shippers, e.g., the BNSF coal dust mandate, or imposing shipment size limits like those challenged by the State of Montana in Docket No. 42124.

Recourse under the Board's unreasonable practice jurisdiction it is important to ARC, et al. and other shippers because STB rate reasonableness remedies are limited and extremely expensive, and because the quality, terms and conditions of services and rate levels for services are two sides of the same coin.

Railroads reluctant to impose high rates and high rate increases on shippers may be rare, but pricing is not the only option for railroads seeking to cut back on service. Just as, say, manufacturers of detergent can increase prices, or achieve the same result by maintaining existing prices but reducing what the consumer gets for that price, railroads can increase profits by raising rates and charges (which they do), or by providing less service for what they charge (which they also do).

ARC, et al. hope that improved competitive remedies like those under consideration in this proceeding will provide more shippers with more effective competition, rather than more apparent but ineffective competition. However, for reasons set forth above, we believe that, in many cases, the only result may be an increase in the appearance but not the reality of competition. Moreover, we know that for many shippers, particularly smaller agricultural shippers and isolated shippers in large Western states, nothing will change, because railroads newly enabled to provide service alongside the incumbent railroad will decline to do so.

Railroad efforts and ICC and STB decisions over several decades have built up layers of obstacles to effective competition and effective regulation. ARC, et al. do not expect the Board to eliminate all of these barriers at once or in a single proceeding, and this proceeding is a start. However, the Board should recognize that its focus on competitive remedies must not come at the expense of the exercise of other aspects of its regulatory jurisdiction that may be of more importance to a greater number of captive shippers.

Respectfully submitted,

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Oklahoma Wheat Commission
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Texas Wheat Producer Board
Washington Grain Commission
Montana Farmers Union

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